THE UNCERTAIN FATE OF MORTGAGE FINANCE:

A Case History in Complexity Risk

Karen Shaw Petrou

Managing Partner

Federal Financial Analytics, Inc.

Lecture Prepared for the

Haas School of Business

University of California

Berkeley, California

February 29, 2012

When I did my graduate work here in political science a geological period of time ago, the business school was just a floor below my department but it could have been in LA for all we knew. Then, government was one school and business very much another, with the discipline separated by an abyss because each was seen as studying something wholly separate and apart. You know better – that's the topic of your course. But, one reason the course is being taught on the policy drivers of financial markets is that we need to learn lots more about them. This is true in every sector of financial markets, but perhaps nowhere is the challenge as pressing as in residential-mortgage finance. Today, about the only mortgages that get made are guaranteed by the federal government, with private markets paralyzed by an array of rules meant to punish sins of the past that could well doom any hope of future private mortgage finance.

That there were sins of the past is sadly evident throughout financial markets, but perhaps nowhere as manifest or manifold as in residential mortgages. Importantly, it wasn't just evil mortgage financiers that brought markets to their knees and pushed borrowers out of their homes. If the mortgage-finance market committed sins of commission, regulators compounded them with sins of omission. As early as 2002, analysts and a few brave regulatory staffers saw trouble brewing. But, it took until late 2006 before federal agencies issued weak guidance – they couldn't bring themselves to write a binding rule – on "non-traditional" mortgages that did little more than remind bankers to be careful when they made loans to borrowers without documentation for speculative housing backed by no money down. Some have blamed the financial crisis solely on the misdoings at Fannie Mae and Freddie Mac, misdoings they claim were entirely the result of governmental demands that the GSEs back "affordable housing." However, in my view, the crisis came from far more complex sources than just the admittedly serious misdeeds of the GSEs – again, misdeeds made possible by a stand-aside regulator.

Clearly, business and government collided here to work in tandem to create a maelstrom of bad practice and complicit regulation. But, that was then. What now? The start of the mortgage meltdown dates to the summer of 2007, leading to market forces that created the spiral of Bear Stearns' failure in early 2008 and, then, all the subsequent turmoil that led to the complete catastrophe later that summer. So, where are we almost a full five years after the mortgage crisis precipitated a global market debacle unprecedented since the Great Depression?

Fannie and Freddie went into conservatorship in September of 2008 and still languish there today. The Federal Housing Administration (FHA) has grown dramatically, but now stands perilously close to needing a taxpayer bail-out all its own. And, private capital – which fled mortgage finance in 2007 – is paralyzed on the sidelines, with the government responsible for ninety percent of mortgage finance despite the parlous condition of all of the agencies involved.

Why are we in this high-risk mortgage standstill and what could get us out? Bad business practice got us into it, but good government now needs to get us out. In the remainder of my talk, I'll outline actions government officials have taken that, in my view, have worsened and prolonged the mortgage crisis. Then, I'll suggest some near-term actions that might revive this critical sector.

The Complexity-Risk Culprit

As you know, I've coined the term "complexity risk" to describe the market result of too many convoluted rules trying to do too much too soon. Arguing against complexity risk is not, I emphasize, a back-door defense for deregulation – in fact, some of the simple rules I suggest are tougher than those now being advanced for the nation's largest banks. Simple rules aim at two vital, clear goals: the innocent are protected and the guilty are punished, using clear standards to which firms can be readily held accountable to meet these two objectives.

And, one more important advantage of simple rules – they pass or fail quickly. One major feature of complexity risk is the uncertainty resulting from far-reaching proposals that remain unresolved for protracted periods, freezing capital in place since any prudent investor needs to know the rules before placing a bet.

But, instead of establishing a few clear precepts to bolster consumer protection, enhance prudential lending and sanction offenders, the growing corpus of mortgage regulations remains incomplete and strikes in all directions, smothering any hope of private securitization challenges to the government along the way. Why is this? A short list of the most important pending standards tells the tale. As I go through the rules, let me be clear – I don't think all of them are wrong. Many of them are right in concept and, in some cases, even in detail. But, taken together, all of these rules won't stabilize U.S. mortgage finance. Instead, they'll end it except to the extent the government steps in.

- **Capital**: It's clear that prior capital standards needed a do-over after the crisis revealed an array of flaws. But, when capital standards go up, one of two things has to happen: banks raise capital or cut risk. Under current market conditions, raising capital is hard, so most banks are reducing assets. Capital strains are most acute for the largest U.S. banks which are subject to stringent new stress tests forcing high capital "buffers" to ensure banks can withstand even catastrophic risk scenarios. The biggest of the big banks are also to be subjected to a capital "surcharge." Large banks under Basel III also might no longer be able to count mortgage servicing rights (MSRs) as capital – a detail, but one critical to any secondary market for residential finance. Fifty-seven percent of U.S. mortgage originations now come from just four banks. Thus, that which squeezes them strangles mortgages – like it or not.

- **Replacing Ratings**: Dodd-Frank demands that bank regulators delete all references to judgments by credit rating agencies (CRAs). CRAs were among the biggest problems in the market meltdown because they happily granted AAA monikers to junk assets even as investors failed to do even the nominal due diligence that would have pointed to the risks underlying the AAAs. But, replacing ratings is far from easy if one wants – as we should – objective, transparent ratings for credit risk. The banking agencies have proposed a highly-complicated new system that, for securitizations, would essentially shut them down.

- **Legal Risk**: Last week, the Obama Administration and 49 state attorneys general (AGs) struck a $26 billion settlement with five big banks for various and sundry mortgage-servicing problems. Some say the settlement was too tough and others too easy, but none can say it ends the legal risk still hanging over mortgage finance. No

originator can yet know the rules that govern future mortgage origination and securitization or the costs it must absorb related to prior mortgage originations. Reflecting this uncertainty, the third largest mortgage originator in the U.S., Bank of America, last week said it won't sell loans any more to Fannie Mae, a decision I think presages a broader exit from this unsettled area.

- **Risk Retention**: This seemingly-technical rule is among the biggest wet blankets on the mortgage market. Conventional wisdom has it that originators need to retain risk when they sell a mortgage into the secondary market to align their incentives with those of investors and borrowers. This is, I think, a debatable proposition, but it's one Dodd-Frank settled in favor of risk retention. Last year, the six regulators – yes, six – charged with the rule governing mortgage risk retention issued a proposal that both proposed a very tight definition of risk retention and asked dozens of questions that made clear that the proposal was, at best, a concept release. If the proposal went into effect as drafted, most securitizers would exit the market. As a result, they are awaiting a final rule before considering whether or not to try again in the private-label arena. Ironically, the rule would exempt originations for the GSEs and FHA from risk retention even though many of these are the high-risk loans covered by the aforesaid settlement. If risk retention is so essential, why are taxpayers not protected by it? Better, surely, to mandate prudent securitization practice across the full spectrum of mortgages, but do so carefully to prevent risk migration out of banks into "shadow" firms or to the taxpayer.

- **Liquidity Requirements**: These are among the most important reforms in the regulatory rewrite, since the prior focus solely on capital left this vital risk largely unaddressed in the rulebook. But, several pending proposals would quash mortgages. The Basel III liquidity rules don't consider Fannie and Freddie obligations as fully liquid assets even though markets say they are. Thus, banks that hold big books of these obligations would be penalized. Liquidity facilities from Federal Home Loan Banks – another important avenue for mortgage finance – might also be dinged. The less GSE obligations banks hold, the smaller the GSE market and, thus, the higher the cost of mortgages they guarantee or fund. GSE reform is essential, but doing it through the back door of these liquidity rules will, I think, backfire.

- **Servicing Standards**: This is another technical issue, but again it's critical. Various regulators are considering new pay standards for servicers – big banks that handle payment processing for mortgages sold into the secondary market. Would you stay in a business if you don't know what you are going to be paid? Of course not.

- **Consumer Protection**: That this is needed in mortgages goes without question. That the old rules would have ensured it had they been enforced may be questioned, but, I think, is true. Still, we are building an edifice of new protections atop the old ones, the most important part of which are new standards defining "qualified mortgages," as required by Dodd-Frank. The law is tough and possible rules still more so. Lenders are asking for a "safe harbor" that protects them from legal risk if they meet the new standards. But, so far, the rules would not only set these requirements, but

also offer no presumption of protection. Again, lenders say no loans until some certainty.

Let me say again: I'm not saying that all of these rules are wrong or that everything the industry wants is right. I am saying, though, that the balance between business needs and government demands is now wholly tilted towards a government that can't pick, choose or decide. And, even if it could decide among all of these rules and issue a clear, simple rulebook, capital would stay on the mortgage sidelines until one even more urgent issue is settled: what to do with Fannie Mae and Freddie Mac. Almost four years later and the conservatorship is still as it was, making Fannie and Freddie wards of the state that drive out any hope of renewed private capital in this sector.

Beyond Mortgages to the Financial Market

Housing isn't, though, all that different from other financial-market sectors. Before the crisis, policy-makers stood back, bewitched by what conventional wisdom saw as the omniscience of market forces. Left to their own devices, market-makers all too often gambled with other people's money, sadly with so much of it that the costs of their ill-gotten gains were borne not just by hapless consumers and investors, but also by the national economies and, as it turned out, even the global financial system that once gave finance so much comfort. In the wake of the crisis, almost every financial comment letter to regulators starts out with an admission that "mistakes were made." Official statements say the same, with the only difference between the two being the mistaken party named as the crisis' culprit.

But, who really done us wrong? I think the structural cause of the financial crisis lies in the intersection of government policy and business practice. Rely too much on markets left to their own devices, and capitalism proves "bloody in tooth and claw." But, rely too much on government and the same survival instinct that can eviscerate the vulnerable is so muzzled that evolution is forestalled, leading to inefficiency and stagnation.

How does Dodd-Frank weigh in on the balance between government and market? More broadly, will the blizzard of new banking rules stabilize financial markets or smother them, sowing the seeds for the next round of systemic risk?

I think we are putting our thumbs on the scale to create a dangerous preference for government direction instead of business decision – an error we can correct without in any way going back to the days in which whatever a banker wanted to do was deemed right just because he wanted to do it. Controlling complexity risk – the unintended results of the pile-up of all of the rules aimed at curbing everything all at once – doesn't mean repealing Dodd-Frank or rewriting the capital rules or necessarily undoing each of the new standards being imposed on global banks. It does, though, mean understanding how each of these rules works in tandem with the others and anticipating cross-cutting implications, perverse incentives and lurking risks before we accidentally create a financial system that poses yet another round of systemic risk and, at the same time, chokes off a vibrant macroeconomic recovery.